History, Manhattan and Tax Policy Will Guide Us

Last week, I presented the year-end investment sales statistics for New York City. This week we'll look at where the market is headed from here and, more importantly why.

But first a 2017 recap. In 2017 volume was down 57 percent from the cyclical peak and values in the Manhattan submarket were down across the board, in all major product types, for the first time in this cycle. We are, I believe, 29 months into a local investment sales market correction.

With this as the backdrop, the important question is where we are headed from here.

First, we will look at history. Going back to 1984, when I began brokering in New York, we have had three recessions and four major changes in tax policy. The recessions have all played out differently but have some similar characteristics.

The stock market crash in 1987 led to the Savings and Loan Crisis in the early 1990s. During that recession, volume dropped for five years before recovering and values dropped a whopping 58 percent, on a price per square foot basis, from the peak to the trough.

In the early 2000s, the dot-com bubble burst and the Russian debt crisis created a recession. The volume of sales fell for four years in a row, but average values did not decrease in any year during that period.

When the U.S. housing market crashed in 2008, it catapulted the economy into the Great Recession. The volume of sales in the NYC investment sales market dropped for four years in a row and values dropped, on average, 38 percent from the cyclical peak in 2007 to the trough in 2010.

Based on what this history has shown us, we would expect the volume of sales to continue to fall. After all, we have had four or five years of successive drops in volume after changes in market direction in the past. Thus far, in this correction, we are only two years into a dollar volume correction and three years into a number of buildings sold slide.

History would suggest that we are in store for at least another year or two of reductions in volume.

However, there are some major differences this time: There was no catalytic event to bring the correction on, which would make one expect the correction to be relatively mild. Certainly, nothing like the 38 percent or 58 percent reductions. Additionally, major tax

changes occurred midstream and could pull us out of this downward spiral.

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If we look at the volume trends being only partially through where they have gone historically, we must focus on property value.

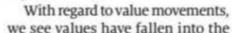
Underlying fundamentals have been eroding for years based on overbuilding that we have seen this time around. Market dynamics are impacted by the constant fight between fear and greed (herd mentality is the third motivator which exacerbates either fear or greed depending on which is winning at the time). From 2010 through 2015, greed was winning and overwhelmingly optimistic developers were buying land at a ferocious pace.

Many of the sites that were purchased in

2010 through 2013 (almost 75 million buildable square feet) were developed or are currently in construction, bringing significant new supply to the market. This new supply exerted downward pressure on rents, driving them down in the residential, retail and office sectors. The reasons for retail rent drops were based on more than supply issues, but that is another topic for another day. These downward pres-

sures on rents impacted values.

When real values are impacted, the direction of the market will change and when this change occurs, volume drops well before values fall. This is because it normally takes sellers 18 to 24 months to tune into the new reality of adjusted value.



red for all property types in Manhattan by the end of 2017. In the outer boroughs the percentage of product types in the red is just 25 percent. We would fully expect values to fall on a more widespread basis throughout the boroughs this year and next.

However, contrary to what many market pundits espouse, market participants' activities are highly sensitive to changes in tax policy. We see spikes in sales volume in 1986, 1998 and 2012, all of which were based on tax policy changes. The first was caused by Tax Reform of 1986, the second by the Clinton administration dropping capital gains taxes from 28 percent to 20 percent in 1998 and in 2012, tax policy had another profound impact on the

market. In 2012, it was clear that a covert 3.8 percent increase in capital gains taxes was imbedded in Obamacare and would become effective in 2013. Additionally, much of the rhetoric leading up to the elections that year included discussions of further increases in capital gains taxes. Based on these dynamics, a landslide of selling occurred, creating yet another spike in sales volume.

So here we are with sales volume sliding and property values turning red around each corner. History says both should drop more.

But the lack of a catalytic event and tax reform will serve to buoy the market and either minimize the expected downward direction or pull the market out of its anticipated track.

Based on the tremendously positive impact tax reform will have on commercial real estate, we expect that the volume of sales will increase by 30 to 35 percent in 2018. Values will likely bottom out this year before rising again in 2019. History, again as our guide, shows that these conditions will not be new. In 1993 volume began to pick up while values hit a cyclical trough. The same thing happened again in 2010 when volume starts to rise and values hit their cyclical low point.

Clearly, no one can predict the future. However, looking at how these trends have behaved over the course of time, knowing that trends begin in Manhattan and understanding that tax policy has a profound impact on the behavior of capital markets participants, all provide good insight into the future. Now we wait to see what actually happens.